SIDLEY & AUSTIN
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

DOCKET FILE COPY ORIGINAL

CHICAGO
DALLAS
LOS ANGELES
NEW YORK

1722 EYE STREET, N.W.
WASHINGTON, D.C. 20006
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711

HONG KONG
LONDON
SHANGHAI
SINGAPORE
TOKYO

FOUNDED 1866

WRITER'S DIRECT NUMBER
(202) 736-8132

WRITER'S E-MAIL ADDRESS
pkeisler@sidley.com

March 10, 2000

Magalie Roman Salas
Secretary
Federal Communications Commission
The Portals
445 12th Street, S.W.
Washington, D.C. 20554

Re: *GTE Corp. and Bell Atlantic Corp., CC Docket No. 98-184*

Dear Ms. Salas:

Attached is a letter from me and a Declaration by Professor John C. Coffee concerning Bell Atlantic and GTE's proposal regarding GTE's InterLATA operations. Please place the attached letter and Declaration in the public record for the above-referenced proceeding.

Yours truly,

Peter D. Keisler

cc: Dorothy Attwood
Rebecca Benyon
Michelle Carey
Kyle Dixon
Jordan Goldstein
Johanna Mikes
Paula Silberthau
Sarah Whitesell
Christopher Wright

ORIGINAL

No. of Copies rec'd 0+4
List ABCDE

SIDLEY & AUSTIN

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CHICAGO
DALLAS
LOS ANGELES
NEW YORK

1722 EYE STREET, N.W.
WASHINGTON, D.C. 20006
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711

FOUNDED 1866

HONG KONG
LONDON
SHANGHAI
SINGAPORE
TOKYO

WRITER'S DIRECT NUMBER
(202) 736-8132

WRITER'S E-MAIL ADDRESS
pkeisler@sidley.com

March 10, 2000

Magalie Roman Salas
Secretary
Federal Communications Commission
The Portals
445 12th Street, S.W.
Washington, D.C. 20554

Re: *GTE Corp. and Bell Atlantic Corp., CC Docket No. 98-184*

Dear Ms. Salas:

On behalf of AT&T Corp. ("AT&T"), this *ex parte* letter responds to several assertions made by Bell Atlantic and GTE (collectively "Applicants") in their Response on their proposal regarding GTE's interLATA assets.[1]

As a threshold matter, it bears emphasis that this particular issue stands on an entirely different footing than the other issues in this proceeding. Those other issues all fall within the Commission's "public interest" authority. In exercising that authority, the Commission has latitude to weigh any claimed public interest benefits against the reduction of actual and potential competition that would occur because of the merger and make a determination concerning whether the merger is overall in the best interests of the public.

By contrast, the interLATA issue does not require or permit the weighing of competing policy considerations. It presents a question of law. Congress has categorically prohibited Bell Atlantic from "own[ing]" or "control[ing]" these interLATA facilities until it first is found to

[1] *See* Response of Bell Atlantic and GTE in Support of Proposal to Transfer GTE Internetworking to a Separate Corporation Owned and Controlled by Public Shareholders (Feb. 22, 2000) ("Response"); Supplemental Filing of Bell Atlantic and GTE (Jan. 27, 2000) ("Supp. Filing").

have opened its local markets to competition (47 U.S.C. §§ 153(1), 271(a)), and has forbidden the Commission from waiving or forbearing from enforcing that prohibition (*id.* § 160(d)).

In their Response, Applicants concede that Section 271 provides the controlling legal standard for analyzing their proposed "divestiture." Response at 2. They assert, however, that Bell Atlantic would neither "own" nor "control" DataCo, the company to which they plan to transfer "substantially all" of GTE's interLATA data assets. *Id.* And in support of this position, Applicants submit – for the first time on reply – a Declaration by Professor Ronald Gilson.

At bottom, both Bell Atlantic and Professor Gilson rest on the claim that it is the form, not the substance, of the proposed transaction that matters. In particular, they contend that the Commission cannot consider the fact that the Class B shares of common stock which Bell Atlantic would possess would include what they call an "option" to take possession of 80% of DataCo. They argue that, for purposes of assessing both ownership and control, it is as if the convertible component of their equity simply does not exist. They never explain *why* that should be so, but simply claim that it is a bedrock principle of law that must be observed.

However, as explained below, and in the accompanying Declaration of Professor John C. Coffee, Jr., the Adolf A. Berle Professor of Law at Columbia University Law School, there is no support for that illogical and unnatural proposition in corporate law or Commission precedent. Indeed, conspicuously absent from Professor Gilson's declaration is citation to authority. That is not because the questions of "ownership" and "control," and the definition of "equity," are not the subject of innumerable statutes, judicial decisions, and agency rules. Rather, it is because, as Professor Coffee demonstrates, all of these authorities make clear that economic reality, not corporate fictions, matter in assessing whether Bell Atlantic will "own" or "control" DataCo, and that Bell Atlantic's so-called "option" is an equity interest that, both alone and in combination with all of the other extraordinary rights Bell Atlantic would retain for itself, establishes Bell Atlantic's ownership and its control over these interLATA assets.

Ownership. There is no dispute as to the economic realities underlying the proposed "divestiture." It is textbook financial economics that the value of equity stock in a company is equal to the present value of the projected earnings stream of that company. R. Brealey & S. Myers, *Principles of Corporat Finance* 60 (1991). Here, the market will recognize that the Class B shares that Bell Atlantic would receive will be converted in the near future, and that at that time Bell Atlantic (or any entity to whom Bell Atlantic might sell its Class B shares) will have a right to 80% of DataCo's earnings. The market will further recognize that, because of Applicants' so-called "Investor Safeguards," there is no means by which the Class A shareholders can obtain access to any of DataCo's "economic returns" prior to the time Bell Atlantic converts its Class B shares. Opposition of AT&T Corp. to Applicants Proposal Regarding GTE's InterLATA Operations, at 8-10 (Feb. 15, 2000) ("AT&T Opposition"). Thus, as Applicants concede, these basic principles make clear that that the market would value the DataCo shares being sold to the public (the Class A shares) at about 20% of the total value of DataCo, and the Class B shares being issued to Bell Atlantic at about 80% of DataCo. Response at 8; *Ex parte* Letter from Patricia Koch to Magalie Salas, Att. 2 (Dec. 24, 1999). In other words, Bell Atlantic's Class B shares would represent a claim to 80% of DataCo's earnings and would be priced accordingly by the market.

It is because this economic reality is indisputable that Applicants and their expert, Professor Gilson, must so vigorously contend that the Commission may artificially treat Bell Atlantic's Class B shares as being composed of two separate and independent instruments – "pure" common voting stock and an "option" – and analyze the transaction solely on the basis of the "pure" common voting stock. Response at 4-7; Gilson Aff. ¶ 14. In other words, Applicants argue that in determining whether Bell Atlantic would "own" DataCo only the 10% "pure" common voting stock component of its Class B shares is relevant and that the Commission may permissibly disregard the value of the "option" component because that is mere "future equity." Response at 4-7. As Professor Coffee explains, this is contrary to basic principles of corporate and securities law.

First, Bell Atlantic would be obtaining – in both form and substance – a *single* equity instrument: Class B stock. Coffee Dec. ¶¶ 24-26. These Class B shares carry all three of the "indicia" of equity – voting rights, earning rights and liquidation rights. *Id.* As Professor Coffee explains, there is "no meaningful sense" in which Bell Atlantic could be said to hold a separate "option." *Id.* ¶ 19. *See also id.* ¶ 16 (this claim is a "sham" "because, unlike a real option, there is no economic decision, and nothing is surrendered or given up").

Thus, Applicants concession that these Class B shares reflect 80% of the value of DataCo is dispositive. Section 153(1) prohibits a BOC from having more than a 10% "equity" interest in a company providing interLATA services. Section 271 is violated even where a BOC may have only 10% of the voting rights but is otherwise entitled to more than 10% of the economic returns of the company. Because it is undisputed that the Class B shares are equity securities and entitle Bell Atlantic to more than 10% of the economic value of DataCo (in fact, 80%), the proposed transaction is forbidden by Section 271. *See Coffee Dec.* ¶ 13.

Second, and in any event, even if the Commission could legitimately pretend that Bell Atlantic would be holding two separate instruments – "pure" common voting stock valued at 10% of DataCo and an "option" valued at 70% of DataCo – the Commission could not disregard the "option" for purposes of considering whether Bell Atlantic would "own" DataCo. Section 153(1) is broadly written to prevent such attempts to elevate form over function. It prohibits both "direct" and "indirect" ownership. And in defining ownership, it makes clear that equity or its "equivalent" should be considered. Two things are "equivalent," of course, if they are equal in value. Black's Law Dictionary (7^{th} ed. 1999). And because the Class B stock would be valued at 80% of the value of DataCo – as Applicants concede – then it is must be considered "equivalent" to an 80% equity interest in DataCo. *See* Coffee Dec. ¶ 20.

Nonetheless, while Applicants admit that some debt, partnership and other interests might be "equity" or its "equivalent" for these purposes (Response at 5), they contend that cannot be true for options. According to Applicants, Section 153(1) "must be interpreted" (Supp. Filing at 37 n.22) to exclude "potential future equity interests" because corporate and securities law maintains a sharp distinction "between an option and equity security" (Gilson Aff. ¶ 17; Response at 3) and because this putative principle is also reflected in the Commission's rules (Response at 3). They are wrong on all counts.

Even assuming Bell Atlantic would have an "option," there is no background principle of corporate law which maintains a sharp distinction "between an option and an equity security."

Indeed, precisely the opposite is the case. As Professor Coffee explains, while the Communications Act does not define "equity security," the federal securities laws do. Coffee Dec. ¶¶ 15-26. The Securities Exchange Act of 1934 defines the term "equity security" to be:

> any stock or similar security; *or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscriber or to purchase such a security*; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

15 U.S.C. § 78c (emphasis added). Thus, rather than there being a "sharp boundary between an option and an equity security," the federal securities laws treat options as the express equivalent of an equity security.

Similarly, Rule 16a-4 of the Securities and Exchange Commission ("SEC") Rules, 17 C.F.R. § 240.16a-4, provides that "[b]oth derivative securities and the underlying securities to which they relate shall be deemed to be the same class of equity securities . . . ." Options are derivative securities[2] and thus, consistent with the common sense notion that "you are equivalent to what you are convertible into" (Coffee Dec. ¶ 15), the securities laws treat options as the equivalent of the underlying security.

Federal court and administrative precedent is fully consistent with this analysis. As Professor Coffee explains, in determining whether an instrument is "equity" the courts and the Securities and Exchange Commission ("SEC") apply the well-established "integration doctrine" and look broadly to the entire transaction and all rights possessed by the putative holder. *Id.* ¶ 29 (citing *SEC v. Cavanagh*, 1 F. Supp.2d 337, 363-64 (S.D.N.Y. 1998)).

For example, in *SEC v. Texas International Co.*, 498 F. Supp. 1231 (N.D. Ill. 1980), the Court agreed with the SEC that a company buying up claims that would be converted into stock was buying up "equity securities" in that company. The court found that in making this determination, "form should be disregarded for substance and the emphasis should be on economic reality." *Id.* at 1240 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

Similarly, in *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988), the Court was faced with the issue of whether the right to purchase a security should be considered a security within the meaning of the federal securities laws. In holding that it was, now-Justice Ginsburg announced a broad principle fully applicable here: "The right to purchase an instrument denominated 'stock' . . . we think, would be subject to the same test for application of the securities laws as the instrument itself." *Id.* at 1288. Those principles, of course, are registration and disclosure requirements designed to ensure, *inter alia*, that investors know who owns and controls a company so that they can make informed decisions about purchasing and selling securities. *See, e.g.*, H.R.Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934); *Santa Fe Indus.*,

---

[2] Rule 16a-1(c), 17 C.F.R. § 240.16a-1, defines "derivative securities" as "any option, warrant, convertible security, stock appreciation right, or similar securities . . . ."

Inc. v. Green, 430 U.S. 462, 477-78 (1977); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 (D.C. Cir. 1978).

And in *Magma Power Co. v. Dow Chemical Co.*, 136 F.2d 316 (2d Cir. 1998), the Court was required to apply the insider trading laws to options to purchase stock. The Court observed that "holding derivative securities is functionally *equivalent* to holding the underlying equity security . . . since the value of the derivative securities is a function of or related to the value of the underlying equity security." *Id.* (emphasis added); *id.* (SEC considers options to be the "functional equivalent" to "underlying stock"). And where, as here, the exercise price of the option is fixed, trading the option is in all relevant respects the same as trading the security itself. *Id.* at 322.

In contrast, the exercise of an option is a non-event for these purposes. *Id.* That is because the exercise of an option changes only the "form" of ownership and does not alter the underlying economic realities. Ownership Reports and Trading by Officer, Directors and Principal Security Holders, 48 SEC Docket (CCH) 216, 234 (Feb. 8, 1991); *See also id.* n.151 ("Although the derivative security is surrendered, this is simply a procedural step to receive the underlying securities. There is no change in profit potential, as the profit potential relates to the underlying security.").[3]

Thus, Applicants' claimed "background rule of law" (Response at 8) does not exist. Applying the "integration doctrine" and these precedents to Applicants' proposal makes clear that even if Bell Atlantic were holding an "option" apart from common stock it would still own DataCo. *See* Coffee Dec. ¶¶ 25-26. Moreover, those principles are especially applicable here, because of all the additional rights that Applicants have also reserved for themselves. As Professor Gilson concedes (¶ 26), Bell Atlantic's consent must be obtained for virtually any significant transaction, agreement, or action DataCo might enter into or take. Thus, Bell Atlantic can "vote" on significant corporate matters – indeed, override the vote of the Board of Directors – simply by withholding its consent. Further, these consent rights expressly can be used to prevent the distribution of earnings to the Class A shareholders until Bell Atlantic exercises its "option." Thus, this "option" carries with it earnings and distribution rights by virtue of its negative blocking power (power which the ordinary option holder does not have). In short, Professor Gilson's "option analogy fails at every level." Coffee Dec. ¶ 25.

Nor has the Commission taken a different course in its own rules. To the contrary, as AT&T demonstrated in its Opposition (at 12-18), the Commission consistently disregards arguments based on form and instead analyzes the reality of a transaction to determine ownership

---

[3] The only federal precedent Applicants cite (Response at 8 n.8) – *Nerken v. Standard Oil Co.*, 810 F.2d 1230 (D.C. Cir. 1987) – is expressly inapposite. That case was about whether a contractual requirement that 40% of "*outstanding common stock*" be owned by a particular entity had been triggered. The Court held that this contractual requirement had "narrowed" the concept of ownership for purposes of that transaction to "outstanding common stock," and therefore expressly held that it was irrelevant whether a prospective right to own stock is ownership under the law generally. *Id.* at 1232.

and control. Indeed, that is the recurring theme of the Commission's decisions in this area. Thus, for example, in *Fox Television Stations, Inc.*, 10 FCC Rcd. 8452 (1995), the Commission addressed the issue of whether a foreign investor that paid in more than 99% of the capital of the company for common stock representing only 24% of the company "owned" more that "one-fourth the capital stock" of that company. The Commission rejected the claim that it could only consider the 24% of the voting stock the foreign investor owned in making this determination, instead finding that where, as here, "the ownership of corporate shares does not correspond to the beneficial ownership of the corporation, we will not be bound by a formalistic and formulaic 'count-the-shares' approach that understates the true extent of ownership." *Id.* ¶ 36.

Because of these and other similar precedents, Applicants largely abandon their reliance on Commission precedent and instead resort to histrionics to defend their transaction, going so far as accusing AT&T of "a dishonest use of Commission precedent" and "an overdose of hyperbole." Response at 2. While AT&T understands that the Commission is fully capable of reading the precedents AT&T cited and discussed in its Opposition to determine for itself what they say, there can no doubt that it is Applicants that have misread the authorities which they discuss. The Commission's *Cable Attribution Order* – their principal such authority – is a case in point. *See Implementation of Cable Television Consumer Protection and Competition Act of 1992*, CS Docket No. 98-82 (Oct. 20, 1999).[4]

In that order, the Commission was concerned that its existing cable attribution rules – which focused on whether an investor owned more than 5% of the voting equity of a cable company – were inadequate. *Attribution Order* ¶ 83.[5] The Commission feared that investors were also able to obtain ownership and control of cable companies through other nonvoting instruments like preferred stock and debt. *Id.* In response to this concern, the Commission adopted the "equity plus debt" rule. As codified in 47 C.F.R. § 76.501, that rule states that where an entity holds interests in a cable company – regardless of whether they are voting or nonvoting, equity or debt – that are greater than 33% of the total assets of the company, the Commission

---

[4] Applicants continued citation of *Time Warner Cable*, 12 FCC Rcd. 12263 (CCB 1997) is puzzling in light of the fact they do not disagree that (1) this is a Cable Bureau decision that was superseded by the Commission's subsequent *Cable Attribution Order*; (2) the Cable Bureau in that case rejected the notion that future interests "do not count as equity interests until conversion is effected" instead finding (¶ 19 n.49) that "it is necessary to examine the economic realities of the transaction under review and not simply the labels attached by the parties"; and (3) their original claim that this Order supported their position was based on the fact that they had quoted the Bureau's summary of Bell Atlantic's stated position (from the prefatory portion of the order that merely describes the parties' positions) and treated that portion of the order as if it stated the Bureau's own views. *Compare* Supp. Filing at 36-37 *with* AT&T Opposition at 14.

[5] AT&T has petitioned for review of this order and challenged several of the rules promulgated by the Commission there. Nonetheless, while AT&T believes that the Commission's attribution rules are overinclusive, the Commission cannot ignore the principles it found controlling in that context in the present transaction.

would treat the investor as effectively owning the cable company for purposes of its substantive cable rules. *See id.*, Note 2(i).

Applicants nevertheless assert that the Commission for some unexplained reason did not include "options" in its equity plus debt rule. Applicants rely on Note 2(i), which qualifies the general rule (contained in Note 2(e)) that holders of "instruments such as warrants, convertible debentures, options or other non-voting interests with rights of conversions to voting interests shall not be attributed unless and until converted." Note 2(i) provides that, notwithstanding Note 2(e):

> the holder of an equity or debt interest or interests in an entity covered by this rule shall have that interest attributed if the equity (including all stockholding, whether voting or nonvoting, common or preferred, and partnership interests) and debt interest or interests, in the aggregate, exceed 33 percent of the total asset value (all equity plus all debt) of that entity.

According to Applicants, "while debt and non-voting stock are attributable under Note 2(i), the other interests listed in Note 2(e) – namely 'options' – are not counted." Response at 11.

As an initial matter, it bears repeating that this is an academic dispute. As discussed above, Bell Atlantic would not own an "option" to obtain stock in the future, but would own *voting* shares that Applicants themselves concede would be worth 80% of the value of DataCo. Hence, there can be no dispute that ownership of the Class B shares would exceed the Commission's 33% percent threshold.

In any event, Applicants' reading of Note 2(i) to exclude convertible interests is refuted by Note 2(e). The Commission would make no sense for the Commission in Note 2(e) to list specifically convertible instruments as subject to Note 2(i) if these instruments were excluded altogether from the scope of Note 2(i). Rather, if that is what the Commission wished to do, it would simply have omitted convertible instruments from 2(e) altogether or noted that they were never attributable until conversion is affected.

Most dispositively, the Commission has itself made explicit that Applicants' interpretation of the "equity plus debt" rule to exclude options is wrong. It addressed and resolved that issue in its discussion of that rule in the context of its "LEC test" in note 329 of the *Cable Attribution Order*. As AT&T explained in its Opposition (at 13-14), 47 U.S.C. § 543 grants cable operators that face competition from a "local exchange carrier or its affiliate" relief from certain rate regulations. In its *Cable Attribution Order*, the Commission addressed the claim by Time Warner that a company is an "affiliate" of a LEC where the LEC holds only "options, warrants, and convertible debentures" to purchase voting stock in that company. *Id.* ¶ 129 n.329.

The Commission determined that it would use its equity plus debt rule in determining whether a company is an "affiliate" of a LEC. *Id.* ¶ 129. And in explaining how this rule would work where the LEC holds "options, warrants and convertible debentures," the Commission observed:

> We do not believe that these types of securities demonstrate the type of current, active participation by a LEC envisioned by the LEC test, *unless the amount of these securities that an investor holds is more than 33% of the total assets of a company.*

Id. ¶ 129 n.329 (emphasis added).[6]

The Commission's findings in this regard are fatal to Applicants' argument. There is simply no basis in logic for claiming that a company that would be an "affiliate" of a LEC for purposes of Section 543 would not be an "affiliate" of a BOC for purposes of Section 271 – especially in light of Applicants' admission that the Commission's cable attribution rules serve the same fundamental purpose as Section 271. *See* Supp. Filing at 37. Equally important, in determining the meaning of "affiliate" for the purposes of the LEC test, the Commission was interpreting Title VI's definition of "affiliate," 47 U.S.C. § 522(2). As the Commission recognized in that order, Section 522(2)'s definition of "affiliate" is much *narrower* than Section 153(1) because unlike the former provision, the latter includes both "direct" *and* "indirect" ownership *and* interests that are the "equivalent" of an equity interest. *Cable Attribution Order* ¶¶ 159-61. Yet Applicants' proposal would fail even the test under that narrower definition.[7]

In short, the Class B shares are pure equity instruments entitling Bell Atlantic to 80% of DataCo in clear violation of Section 271. Further, even if Bell Atlantic could decompose its Class B shares into separate instruments as it claims, this transaction would still flunk Section

---

[6] When Applicants quoted this passage in their filings with the Commission, they reproduced it in the following form:

> We do not believe that these types of securities demonstrate . . . current, active participation.

Supp. Filing at 37. By placing a period after "participation" and omitting the "unless" clause, Applicants made the passage appear to stand for the opposite of what it actually said.

[7] Applicants make only a half-hearted attempt to defend their other initial claim that the MFJ precedents support their position. *See* Response at 12-13. After AT&T demonstrated (at 18-19) that the proposed transaction would flunk the three-part test developed by Judge Greene for evaluating whether a BOC's acquisition of an option violated the decree, Applicants cautioned that "[n]o authority requires the Commission to apply the same factors Judge Greene developed under the MFJ when considering whether options or other conversions rights acquired by the BOCs are consistent with sections 3(1) and 271 of the Act." Response at 13. That is true, but these precedents clearly refute the notion that there is a well-established principle that "options" are mere "future interests" that are irrelevant to whether a BOC has an ownership interest in another company. Rather, the MFJ court found that "manipulations of form should not obscure real economic incentives underlying . . . [a particular business] relationship." *United States v. Western Elec. Co.*, Civ. Action No. 82-192, slip op. at 3 (D.D.C. Aug. 7, 1986) (citation omitted). And as shown *supra*, this is the same principle that is applied both in corporate law generally and in the Commission's own decisions.

271 because it is well-established under the corporate and securities laws that an "option" is "equivalent" to the underlying security.

Control. Applicants can continue to argue that Bell Atlantic will not control DataCo only by ignoring key aspects of their transaction and pertinent Commission rules, and by misrepresenting the terms of the AT&T-MediaOne merger.

Again, the very same precedent that the Applicants initially cited as serving the same purposes as Section 271 would require the Commission to find that Bell Atlantic would "control" DataCo. That is because the Commission has repeatedly found in both the cable and broadcast context that holding more than 5% of the voting stock of a company gives the investor "control" over that company. *Broadcast Attribution Order* ¶ 10 ("[W]e remain convinced that shareholders with ownership interests of 5 percent or greater may well be able to exert significant influence on the management and operations of the firms in which they invest. . . . In this regard, a growing body of academic evidence indicates that an interest holder with 5 percent or greater ownership of voting equity can exert considerable influence on a company's management and operational decisions."). *See also Cable Attribution Order* ¶¶ 45-50. Here, Bell Atlantic would have more than double that threshold.[8]

Beyond this, it is also well established that possession of an option is a means by which an investor can gain control of a corporation. *See* Coffee Dec. ¶¶ 28-29. As Professor Coffee explains, the courts and the SEC have found that investors obtained control of a company through the use of an option arrangement that is functionally identical to what Applicants contend Bell Atlantic would have here. *Id.* ¶ 29 (discussing *SEC v. Cavanaugh*, 1 F. Supp. 2d 337, 365-66 (S.D.N.Y. 1998)).

Further, considered as a whole, Applicants' so-called "Investor Safeguards" and "Commercial Contracts" ensure that Bell Atlantic would dominate DataCo from day one. *First*, Applicants have ensured that the Board of Directors will be composed of persons of their choosing. Applicants concede (at 21) that Bell Atlantic will have one Board seat and that another Board seat will go to DataCo's CEO – whom they have announced will be Paul Gudonis, who is currently CEO of GTE-Internetworking and who will have every expectation of returning to GTE (as merged with Bell Atlantic) once the "option" is exercised. Applicants claim,

---

[8] In this regard, Applicants should not be heard to argue that application of the Commission's 5% equity voting benchmark would nullify Section 153(1) because that statute authorizes BOCs to acquire up to 10% of the "equity (or its equivalent)" of the company. First, an "equity" interest is not synonymous with the voting stock that is the focus of the Commission's rule; there are numerous other equity interests that BOCs can acquire without triggering the Commission's 5% equity voting threshold, such as preferred stock and limited partnership interests. Further, the Commission has also properly recognized that a 10% equity voting interest would not give control where another person or entity is a controlling shareholder. *Broadcast Attribution Order* ¶ 30. Here, by contrast, Applicants have ensured that Bell Atlantic will be the dominant shareholder in DataCo.

however, that any influence that these Directors would exert would be checked by the other eight "independent" directors.

But there will be no truly independent directors. As Applicants concede, the Applicants themselves will initially select *all* the Directors. *Id.* n.21. While Applicants suggest that this will not matter because there will be elections in the future, these same Directors picked by Applicants will determine who will be on the slate of Directors proposed by DataCo's management to the shareholders in those elections. And there is nothing to prevent these Directors from simply re-nominating themselves; indeed that is common corporate practice. *See* Coffee Dec. ¶ 35.[9]

Although there is a theoretical possibility that dissident shareholders could nominate their own slate and convince a majority of shareholders to back it, that possibility is realistically nonexistent. As Professor Coffee explains, such a proxy fight could not occur because these contests are very expensive and the "Investor Safeguards" ensure that insurgents would not be able to profit from replacing the incumbent management. *Id.* ¶ 35. This is particularly true in light of the fact that under Applicants' proposal no investor can have a voting interest in DataCo in excess of Bell Atlantic's. *See* AT&T Opposition at 26-27.[10]

Second, as AT&T explained in its Opposition (at 25), Applicants have filled key management positions with existing employees. Applicants counter (Response at 23 n.25) that this is akin to suggesting that AT&T controls Qwest because a former AT&T employee (Joseph Nacchio) is that company's CEO. That is just silly. The reason that these Applicants will have control is that these employees know that Bell Atlantic will be formally *re*acquiring DataCo in a few years and will at that time have the ability to remove DataCo's managers (and promote those managers it likes). Put simply, it defies common sense to suggest that DataCo managers would advocate any policy contrary to Bell Atlantic's interest when this would severely damage their future with the company. And by populating DataCo with existing Bell Atlantic and GTE employees, Applicants have ensured that DataCo's managers will have a keen grasp of the business strategies Applicants wish to see implemented over the next few years. Indeed, those employees are presumably the ones that first developed and implemented those strategies on behalf of Bell Atlantic and GTE.

---

[9] In all events, it is well-established principle of corporate law that the mere presence of independent Directors does not prevent a dominant shareholder from exercising control. Coffee Dec. ¶ 31.

[10] Bell Atlantic (Response at 16) and Professor Gilson (¶ 23 n.4) suggest that the Commission should not worry about Bell Atlantic's role in picking the Board because directors have fiduciary duties to shareholders. This argument proves far too much. It would mean that the entire Board could be comprised of Bell Atlantic employees. *See* Coffee Dec. ¶ 34. The reality is that, given the breadth of the business judgment rule, there would be ample room for Bell Atlantic-affiliated directors to cause DataCo to take actions that Bell Atlantic desires without subjecting themselves to fiduciary liability. *See generally* D. Block, N. Barton, S. Radin, *The Business Judgment Rule* Ch. II (5th ed. 1998).

Third, Applicants have ensured that DataCo is dependent upon – and therefore controllable by – Bell Atlantic. Most significantly, Bell Atlantic is even permitted to veto any "agreements or arrangements" that might "materially adversely affect DataCo's results of operation or financial condition." AT&T Opposition at 23-24. And because whether Bell Atlantic's consent is required ultimately requires a guess as to the future impact of any agreement, any prudent manager would routinely request Bell Atlantic's consent for any significant transaction.[11]

Further, it appears that even without these binding restrictions, DataCo would have no choice but to take its cues from Bell Atlantic. Under the guise of the so-called "commercially reasonable contracts" moniker, vital parts of DataCo's business will remain with Bell Atlantic.[12] While Bell Atlantic apparently will not operate interLATA data facilities, it will be involved in aspects of DataCo's Internet business that do not involve interLATA transport, but are a necessary part of the business. Thus, for example, Applicants indicate that Bell Atlantic will provide "Research and Development" for DataCo and manage "Capacity and Network Support" for DataCo. The existence of these contracts also provides a clue as to what Applicants meant when they said they would transfer "substantially all" of GTE's data assets. Supp. Filing at 30.[13] It is hard to imagine how any company could viably operate an Internet backbone business without engaging in R&D or managing the network and ensuring that there was sufficient capacity available. Indeed, the latter is the lifeblood of any Internet backbone provider. Clearly, there is no way DataCo can be independent if it cannot profitably run its business without Bell Atlantic's involvement.[14]

---

[11] Bell Atlantic claims that it is "absurdly overbroad" to claim this provision gives it the right to review "significant agreements contemplated by DataCo." Response at 15. But clearly a "significant agreement" creates the potential for a "material[]" impact on DataCo's business triggering the need to secure Bell Atlantic approval. *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (something is "material" if "a reasonable investor would consider it important").

[12] The fact that Bell Atlantic would charge "commercially reasonable" rates for the services its provides DataCo does nothing to alter the fact that DataCo would be dependent upon Bell Atlantic to remain viable. *Cf.* Response at 25. The concern here is that Bell Atlantic will control DataCo, not that it will gouge DataCo when providing these services.

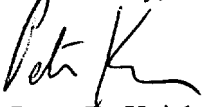
[13] The March 9, 2000 *ex parte* filed by Applicants sheds little light on this critical issue. *See* Ex Parte Letter from Steven Bradbury to Magalie Salas (March 9, 2000). It is telling that Applicants are willing to submit only a cursory summary of the assets they plan to transfer to DataCo but not the actual documents that would control the transfer. However, the one relevant fact that emerges clearly is that BBN Technologies, which performs R&D services for GTE Internetworking, will not be transferred to DataCo. *Id.*

[14] It is also telling that while assuring the Commission that it need not worry about these contracts, Applicants have not provided them for review.

Applicants' attempt to justify these control mechanisms by claiming that AT&T has similar mechanisms in place in connection with its merger with MediaOne is both ironic and wrong. It is ironic because it is hard to see how Applicants can justify the completeness of a putative "divestiture" by pointing to covenants negotiated at arms-length in connection with an imminent *acquisition*. *See* Coffee Dec. ¶ 33.

And it is wrong because the covenants involved in the AT&T-MediaOne merger are nothing like those involved here. As explained by Professor Coffee (¶ 33), the covenants to which Applicants and Professor Gilson refer do not enable AT&T to force MediaOne to do (or not to do) anything. Rather, they are negative covenants that are simply designed to preserve MediaOne intact pending AT&T's acquisition. If MediaOne takes an action that violates one of the covenants, AT&T can walk away from the deal. Here, by contrast, the purpose of the "Investor Safeguards" is not to give Bell Atlantic an "out" from reacquiring DataCo if DataCo changes direction, but rather to make sure that DataCo does not act independently until Bell Atlantic formally recaptures it. Bell Atlantic will have the legal right to force compliance by DataCo with the "Investor Safeguards" it has imposed on DataCo. Indeed, if these "safeguards" did *not* give Bell Atlantic the power that AT&T lacks with respect to MediaOne – *i.e.*, actually to dictate DataCo's significant decisions – they would serve no purpose at all.

Yours truly,



Peter D. Keisler

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, For Consent to Transfer of Control	CC Docket No. 98-184

DECLARATION OF PROFESSOR JOHN C. COFFEE, JR.

INTRODUCTION

1. I make this declaration to respond to the declaration of Professor Ronald J. Gilson, dated February 22, 2000, in the above captioned matter. Although ordinarily I would be reluctant to disagree with my colleague, friend, and co-author, I have previously served as an expert witness for AT&T Corp. ("AT&T") in connection with its proposed acquisition of MediaOne Group ("MediaOne") in another proceeding before this Commission. The AT&T acquisition of MediaOne and the relationship between AT&T and Liberty Media Corporation ("Liberty") are repeatedly referred to in the filings made by Bell Atlantic Corporation ("Bell Atlantic") and GTE Corporation ("GTE"), including in the Gilson declaration, as a precedent that demonstrates that Bell Atlantic will not control DataCo ("DataCo"), the new corporation into which GTE's existing data business will be deposited. As discussed below, I believe these comparisons oversimplify and

are incomplete.

2. Organizationally, this declaration is divided into five sections. In Section I, I discuss my background and competence. In Section II, I provide some relevant legal and historical background because both the Securities Act of 1933 and the Communications Act of 1934 use very similar language relating to the definition of control, and the federal courts and commentators have emphasized that decisions in one context are applicable to the other. In Section III, I analyze Bell Atlantic and GTE's attempt to outflank the 10% ownership ceiling imposed by Sections 3(1) and 271 of the Communications Act of 1934. In contrast to Professor Gilson, but using the same examples as he uses, I conclude that Bell Atlantic would "own" DataCo under the definition specified in Section 3(1) as applied to the proposed capital structure of DataCo. Section IV then assesses the level of control that Bell Atlantic would possess over DataCo, notes that options have been long recognized as a control device, and specifically focuses on the "Investor Protection Mechanisms" that give Bell Atlantic the power to veto certain actions that DataCo's board might otherwise take. I find the level of control possessed by Bell Atlantic over DataCo to be significantly greater, and of a different nature, than the very limited powers held by AT&T with respect to Liberty, and I find the "Investor Protection Mechanisms" established by Bell Atlantic and GTE to play a far more decisive role than do the procedures jointly negotiated by AT&T and MediaOne pending its consummation of the MediaOne acquisition. Section V summarizes my conclusions.

I. BACKGROUND AND QUALIFICATIONS

3. I am the Adolf A. Berle Professor of Law at Columbia University Law School, where I specialize in corporate and securities law. I am also a Fellow of the American Academy of Arts

and Sciences and a Fellow of the American Bar Foundation. I am a member of the bars of the State of New York and the District of Columbia and have also been admitted to various federal courts. I have a B.A. degree from Amherst College (1966), a law degree (LL.B) from Yale Law School (1969), and a master of laws degree (LL.M) from New York University Law School (1976). Between 1970 and 1976, when I entered law teaching, I was a corporate lawyer with the firm of Cravath, Swaine & Moore in New York City.

4. Since 1976, I have taught law on a full-time basis at a number of American law schools (including Stanford Law School, University of Virginia Law School, University of Michigan Law School, and Georgetown University Law Center), and I have been on the Columbia Law School faculty since 1980. I have also been a visiting lecturer at a number of foreign law schools, including the Universities of Sydney, Tokyo and Toronto.

5. From 1980 to 1993, I served as a Reporter to the American Law Institute in its effort to codify the principles of American corporate governance into a Restatement-like form. *See* The American Law Institute, PRINCIPLES OF CORPORATE GOVERNANCE ANALYSIS AND RECOMMENDATIONS (Proposed Official Draft 1992). I am also a co-author of the best selling U.S. casebook on securities law (Jennings, Marsh, Coffee and Seligman, SECURITIES REGULATION: CASES AND MATERIALS (8th ed. 1998), a co-author of a leading corporations casebook (Choper, Coffee, and Gilson, CASES AND MATERIAL ON CORPORATIONS (4th ed. 1995)[1]), and a co-author of a widely used hornbook on corporate finance (Klein and Coffee, BUSINESS ORGANIZATION AND FINANCE (7th ed. 2000)).

---

[1] To underline the high regard that I have for Professor Gilson, I should disclose that I invited him to join the 4th edition of this casebook.

Other books and articles that I have written or edited on the topic of corporate accountability are listed on my resume, a copy which is attached hereto as Exhibit A. Like Professor Gilson, I have also served as Chairperson of the corporate law section (the Section on Business Associations) of the Association of American Law Schools ("AALS") and in addition, I have also served as chairman of the AALS's Audit Committee and other committees.

6. Outside of the academic context, I have just this month completed serving a four year term as a member of the Legal Advisory Board of the National Association of Securities Dealers ("NASD"), which body advises the NASD and is subsidiary, Nasdaq, on corporate governance matters. I was previously a member of the Legal Advisory Committee to the Board of Directors of the New York Stock Exchange, Inc. (and continue as a emeritus member), and have also served as a member of the Subcouncil on Capital Markets of the United States Competitiveness Policy Council (which is an independent federal agency), the advisory boards of several law-related publications (including the Corporate Governance Advisor), and as general counsel to the American Economic Association. Finally, I have served terms as a member of the Committee on Securities Regulation, the Committee on Corporate Law, and the Special Committee on Mergers and Acquisitions of the Association of the Bar of the City of New York.

7. On a number of occasions, agencies of the United States Government (including the Antitrust Division of the Department of Justice, various U.S. Attorneys, the FDIC, the RTC, the SEC, and the IRS) have retained me to testify as their expert witness on matters of corporate law in civil and criminal litigation with the United States. On each such occasion when my testimony or affidavit was offered, I was found to be qualified to testify as an expert witness on corporate issues by the state or federal court hearing the case. Finally, although I would not begin to

suggest that my qualifications are any better than Professor Gilson's, my area of specialization (unlike his) is the federal securities laws, and, as I suggest below, this area is more directly related to the definition of "affiliate" and "control" than is the more abstract field of corporate finance.

II. BACKGROUND AND LEGISLATIVE HISTORY

8. It is noteworthy and probably revealing that my colleague, Professor Gilson, does not cite a single case or statute, or refer to any legislative history, in his declaration. Possibly there are legal issues that can be resolved by brilliant deductive insight, unhindered by messy digressions into the case law, but the meaning of "control" and "affiliate" are not among them. Simply put, these two words are among the most frequently litigated terms in the field of securities law, with literally several thousand cases discussing them in just the LEXIS federal securities library.

9. This case law is highly relevant to any construction of Section 3(1) of the Communications Act of 1934 because there is strong reason to believe the language of the Communications Act of 1934 was modeled after language originally used the year before in the Securities Act of 1933. Indeed, in their definitive treatise, Professors Loss and Seligman conclude as much:

> "The Communications Act of 1934 used the identical control language that is found in the Securities Act definition of the term underwriter." L. Loss and J. Seligman, SECURITIES REGULATION (3rd ed.1990) at p. 1709 (emphasis in original).[2]

Noting that neither statute actually defines the term "control" (id. at 1709), Professors Loss and

---

[2] Professors Loss and Seligman are here referring to the control language in Section 2(b) of the Communications Act of 1934, 47 U.S.C. §152(b)(2), which was later modified, and not to Section 3(1), which was enacted later. However, Section 3(1) of the Communications Act also uses the same essential test for control that is in Section 2(11) of the Securities Act of 1933.

Seligman argue that both statutes have long been interpreted to deem whether a person or entity is in control of a company to be a question of fact that depends on the totality of the circumstances, including at bottom an appraisal of the influence such person has on the corporation's management and policies. For a recent restatement of this standard view, see SEC v. Cavanagh, 1 F. Supp. 2d 337, 366 (S.D.N.Y. 1998). This pragmatic test was actually first announced in Rochester Tel. Corp. v. United States, 307 U.S. 125, 145-46 (1939), under the Communications Act. But it has been followed in a host of securities law decisions.[3]

10. Once one recognizes that the issue of control -- whether under Section 3(1) of the Communications Act or under various provisions of the federal securities laws -- is a factual question focusing on actual influence in the specific case, it follows that a more formal deductive definition, based on principles of corporate finance, is inappropriate. The concerns of corporate finance are primarily focused on valuation. The relevant issue here is more subtle: by what techniques can one have influence or power to determine business policies.

11. One further preliminary observation is relevant. At the time the federal securities laws and the Communication Act of 1934 were written, Congress was very concerned about the ability of promoters to control and manipulate securities through the use of options. In Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 432 (1972), the Supreme Court acknowledged this

---

[3] See, e.g., Myzel v. Fields, 386 F. 2d 718, 735 (8th Cir. 1967) ("The statute ... has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable.") SEC v. North American Research and Development Corp., 424 F. 2d 63 (2d Cir. 1970). Even under the securities laws (which does not have the automatic 10% rule of Section 3(1)), a 10% holder of voting stock has been found to be a controlling person where he held a strategic position and the facts otherwise suggested that he was in a position to dominate the other shareholders. See Ellerin v. Massachusetts Mut. Life Ins. Co., 167 F. Supp. 71, 270 F. 2d 259 (2d Cir. 1959).

history, noting that because "[o]ptions ... played such a large role in the manipulative practices disclosed during the 1930's" they were given special treatment under §16(b) of the Securities Exchange Act of 1934 "because of the opportunity for abuse inherent in the device..." Specifically, the Court said that the mere grant of an option can sometimes be treated as a completed sale of the underlying security (citing Bershad v. McDonough, 428 F. 2d 693 (7th Cir. 1970)). In referring to the "large role" played by options in the abuses that came to light as the federal securities laws were being adopted, the Reliance Court specifically referred to one book, Twentieth Century Fund, Inc., STOCK MARKET CONTROL (1934). See 404 U.S. 418, 433 n. 9. That book, the result of a lengthy study of stock pools formed by securities manipulators during the early 1930's, found that the most prevalent technique used by these promoters was to obtain options on large blocks of stock. See STOCK MARKET CONTROL at 114-118. Although the methodology of stock manipulation as practiced by stock promoters in the 1930's is not central to the disposition of this case, it would ignore history (and the Supreme Court's reading of it in Reliance) to believe that options are not an effective and widely used control device. As discussed later, a number of decisions have so recognized.

III. BELL ATLANTIC'S OWNERSHIP OF DATACO

12. Section 3(1) of the Communications Act of 1934 makes clear beyond argument that Bell Atlantic must be deemed to "own" DataCo if it owns "an equity interest (or the equivalent thereof) of more than 10 percent." In short, not only would ownership by it of an amount in excess of 10% of DataCo's equity be forbidden (at least until such time as the FCC grants long distance authorization pursuant to Section 271 of Communications Act), but so would the ownership by it of any functional substitute for such an equity interest if it can be deemed an

"equivalent" security.

13. Upon the merger of Bell Atlantic and GTE, it is undisputed that Bell Atlantic will receive convertible Class B stock (the "Class B Stock") in DataCo, which Class B stock will be convertible for a period of five years into shares of stock representing 80% of DataCo's voting and distribution rights.[4] The bottom line issue then is whether fashioning the capital structure of DataCo so that Bell Atlantic owns nominally less than 10% but possesses the right for five years to convert this 10% interest into an 80% interest gives Bell Atlantic the "equivalent" of more than a 10% interest. A realist would say: "obviously."

14. Nonetheless, Bell Atlantic and its experts reply that Bell Atlantic owns less than the specified 10% threshold essentially by assuming what is to be proven. Professor Gilson's declaration exemplifies this approach. According to his analysis, Bell Atlantic by definition owns two things: "an equity security carrying voting and distribution rights; and an option to acquire the security into which the original stock is convertible at an exercise price equal to the value of the original stock." (See Gilson Declaration at Para. 14). On this basis, he opines that the only "question posed is whether the option constitutes "equity" for purposes of determining whether... [Bell Atlantic] owns more than 10 percent of DataCo and is therefore an affiliate for purposes of section 271(a)." (Id.)

15. If this is the question -- i.e., whether options constitute equity --, the statutory answer is clear. The definition of "equity security" in Section 3(a)(11) of the Securities Exchange Act of

---

[4] Bell Atlantic's right to convert Class B shares into 80% of DataCo's voting and distribution rights can be diluted by future issuances of Class A Stock, but in this event (at least assuming that it then owns over 70% of DataCo) Bell Atlantic has compensating rights to acquire additional Class A shares of DataCo at their fair market value. These provisions are not germane to my analysis, and I will not discuss them in any further detail.

1934 defines "equity security" to include:

> "any security convertible, with or without consideration, into such a security; or carrying any warrant or right to subscribe to or purchase such a security;..."

In short, both options and convertible debt securities are treated as equity securities on the premise that a security is equivalent to what it is convertible into. As discussed below, this premise is extended further in several key SEC rules.

16. Although Professor Gilson is not wrong in saying that conceptually any convertible security can be treated as if it had two component parts, the convertible security can also be treated as if it were the equivalent of the security into which it is convertible. The relevant question for this litigation is which approach makes greater sense. Here, I will advance three basic arguments:

(1) It has been the consistent approach of the federal securities laws to view derivative securities (and particularly convertible securities) as equivalent to the class into which they are convertible; in short, rather than decompose the convertible security into separate elements, the convertible security is normally viewed as the equivalent of the underlying security.

(2) The division of Bell Atlantic's rights into an equity security plus an option distorts reality where the asserted "option" consists simply of the right to convert a 10% share of the DataCo's cash flow into an eighty percent share of the same cash flow. Essentially, this is a sham transaction because, unlike a real option, there is no economic decision, and nothing is surrendered or given up (in contrast to a true convertible security, where a senior security is surrendered, or a true option, where a strike price is paid); and

(3) Although Professor Gilson asserts that a naked option cannot be equivalent to an

equity security because it lacks voting and other rights, Bell Atlantic in fact has these rights once we view the transaction on an integrated basis. Bell Atlantic's overall voting rights protect the value of its conversion option and thereby strengthen the case for treating this conversion right as equivalent to stock ownership.

17. The normal attitude of the federal securities laws toward convertible securities is shown by Rule 16a-4 ("Derivative Securities") under the Securities Exchange Act of 1934. Subsection (a) of this rule provides that for purposes of Section 16 of the 1934 Act:

> "[B]oth derivative securities and the underlying securities to which they relate shall be deemed to be the same class of equity securities, except that the acquisition or disposition of any derivative security shall be separately reported."

In short, both an option and a convertible security (each of which are derivatives) are treated as "equivalent" to the underlying security.[5]

18. Such an approach makes even greater sense on the instant facts. The Class B shares simply do not resemble an ordinary convertible stock. In the case of an ordinary convertible security, the holder surrenders something of value (a right to interest and principal in the case of a convertible bond or a right to a senior dividend which has a priority over the common's dividend rights in the case of a convertible preferred) in order to effect the conversion. Similarly, in the case of an option, the holder exercises only when the price of the stock exceeds the exercise price

---

[5] One qualification is necessary. In the case of a convertible stock that has its own voting rights, the case law has said that it must be treated both ways. That is, for purposes of the 10% ownership test that is also the critical level under Section 16(b) of the Securities Exchange Act of 1934, the holder is liable if it holds either (i) more than 10% of the convertible security, or (ii) more than 10% of the voting power of the underlying class after an assumed conversion of the convertible security. See Morales v. New Valley Corp., 936 F. Supp. 119, 125 (S.D.N.Y. 1996). In effect, one looks at the transaction from all possible perspectives to determine if there is a controlling influence.

of the option (that is, if the option is to purchase at $100 per share and the stock never reaches that level, the option will expire unexercised). Inherently, in the case of either an option or a convertible security, there is a possibility of non-exercise. For example, if economic conditions deteriorate or stock prices fall, one may prefer to hold the convertible debenture or convertible preferred which has senior claim on the corporation's assets or earnings.

19. But this is not the case here. Because the Class B stock receives 10% of DataCo's voting and distribution rights and can be converted into 80% of its voting and distribution rights (for five years), there is no state of affairs under which conversion should not occur. Even if the FCC does not grant long distance authorization to Bell Atlantic pursuant to Section 271 of the Communications Act, Bell Atlantic can simply sell its Class B shares to another party who would control DataCo. Thus, whether the economy prospers or deteriorates, whether stock prices rise of fall, conversion is inevitable because 80% of DataCo's cash flow is better than 10%. The greater subsumes the lesser. In this light, what Bell Atlantic really has is not a true "option," but the sham right to convert $1 into $8 for five years. In no meaningful sense is this an "option" (because there is no possibility of non-exercise); rather, it is the "equivalent" of $8. Put differently, where there is no possibility that the Class B shares will not be converted into Class A shares, then the two classes become equivalent.

20. In determining when some other interest should be aggregated with stock ownership or treated as a substitute, Section 3(1) of the Communications Act uses the critical phrase "or the equivalent thereof." Lexically, the dictionaries agree that two things are equivalent if they are

equal in value and effect.[6] Thus, if the Class B stock has a value equivalent to 80% of the value of DataCo, this evidence would strongly support a conclusion that it is equivalent to an 80% interest in DataCo. In their "Response of Bell Atlantic and GTE In Support of Proposal to Transfer GTE Internetworking to a Separate Corporation Owned and Controlled by Public Shareholders," dated February 22, 2000, counsel for Bell Atlantic has conceded that the Class A shares will trade at "somewhere above 20% of DataCo's value as a business." (Response at p.8). This concession is tantamount to recognizing that Bell Atlantic's conversion right has a value equal to approximately 80% of DataCo and is thus "equivalent" to such an ownership stake. So long as it is recognized that the Class A shares will reflect only around 20% of DataCo's value, it cannot be rationally argued that Bell Atlantic owns less than 10% or the equivalent of DataCo.

21. Professor Gilson attempts to respond to this equivalence by focusing on the "sharp boundary between an option and an equity security" (Gilson Declaration at Paragraph 17). Holding aside for the moment the fact that an option is always an "equity security" as a matter of law under Section 3(a)(11) of the Securities Exchange Act of 1934, I agree with Professor Gilson's contention that it is instructive to focus on how the federal securities laws treat options and convertible securities. Already, I have focused on Rule 16a-4. Instead, Professor Gilson focuses on Rule 144. His apparent point is that the holder of an option gets no credit against the holding period (now, one year) for restricted securities for the earlier period of time that the holder held that option. That is, if I hold an option for a year and then exercise, I must hold the security so acquired for one additional year before I have satisfied the requisite holding period

---

[6] Black's Law Dictionary (7th ed. 1999) defines "equivalent" to mean "1. equal in value, force, amount, effect, or significance; 2. corresponding in effect or function, nearly equal, virtually identical." Several other dictionaries give "equal in value" as their preferred meaning.

under Rule 144(d)(1). True as this is, it ignores the much more relevant point for this case: if I hold a convertible stock or debenture for one year and then convert it into the underlying security, I do not need to hold that underlying security for a day longer: rather, my holding periods are "tacked." Specifically, Rule 144(d)(3)(iii) provides:

> "(ii) Conversions. If the securities sold were acquired from the issuer for a consideration consisting solely of other securities of the same issuer surrendered for conversion, the securities so acquired shall be deemed to have been acquired at the same time as the securities surrendered for conversion."

In short, a radical distinction is made by Rule 144 between an option and a convertible security, because the holder of a convertible security is deemed to have borne "the full risk of the investment" (in Professor Gilson's phrase).

22. Rule 144 also contains another instructive lesson. Rule 144(e) places volume limits on how much "restricted securities" can be sold during any three month period. But when both convertible securities and the underlying security are both sold during any three month period, Rule 144(e)(3)(i) provides that "the amount of convertible securities sold shall be deemed to be the amount of securities of the class into which they are convertible for purposes of determining the aggregate amount of securities of both class sold."

23. Like Rule 16a-4, Rule 144 treats convertible stock as the equivalent of the underlying stock into which it is convertible, both for purposes of determining the holding period for restricted securities and the volume that may be sold. Thus, to the extent that we look to Rule 144 for a relevant analogy (as Professor Gilson suggests we should), it furnishes exactly the opposite implication than he suggests: convertible securities (but not options) are treated as equivalents of the underlying security. On this basis, the Class B shares are the "equivalent" of

the Class A shares.

24. Professor Gilson also argues that an option is not equivalent of an equity security because it lacks voting rights, earning rights, and liquidation rights (See Gilson Declaration at Paragraph 15). But this is true only in his thought experiment which treats the Class B shares as if they were two things: an equity security and a naked option. In fact, the Class B shares are what they say they are: a convertible security carrying all three rights. As just noted, the federal securities laws do not adopt the theoretical approach of much corporate finance scholarship and decompose a convertible security into an option plus a fixed income security; rather Rule 144 distinguishes radically between options and convertible securities, treating the latter as equivalents of the underlying stock.

25. More importantly, in evaluating issues of ownership and control, the federal securities laws consider not just the formal terms of an instrument, but the facts of the entire transaction. Here, even if we were to consider Bell Atlantic to be holding a simple option (as Professor Gilson proposes), it is still the case that they have important voting rights which inhere in other portions of the total transaction. As Professor Gilson discusses at Paragraph 26 of his declaration (at p. 14), Bell Atlantic must consent to virtually any significant transaction, agreement, or action that DataCo might take or enter into prior to the conversion of its Class B shares. My point is not that these rights are inherently illegitimate, but that they amount in effect to voting rights that a simple option holder would not have. The option analogy then fails at every level, because Bell Atlantic can vote indirectly by withholding consent. Further, these consent rights can be expressly used to delay any significant distribution of assets or extraordinary dividend to the Class A shares until the time at which Bell Atlantic converts its Class B shares. Hence, the Class B shares do have earning

and distribution rights by virtue of their negative blocking power (which power an option holder does not have).

26. My assertion that the federal securities laws look broadly to the entire transaction and all rights possessed by a putative control holder is based upon the well-known "integration doctrine" that the SEC has long used across a range of doctrinal questions. See, e.g. SEC v. Cavanagh, 1 F. Supp. 2d 337, 363-64 (S.D.N.Y. 1998), (applying an "integrated" analysis to the determination of control questions). Here, such an integrated analysis shows that Bell Atlantic has carefully protected itself from earnings or asset depletion during the period prior to the projected conversion of its Class B shares. When such rights are combined with its certain ability to convert its 10% stake in DataCo into an 80% stake, it is clear that it already owns that 80% stake in the sense of holding a bundle of property rights far greater than those possessed by a simple 10% shareholder.

IV. BELL ATLANTIC'S CONTROL OF DATACO

27. Under the definition of "affiliate" in Section 3(1), Bell Atlantic can neither "own" nor "control" DataCo without prior FCC approval. Thus, even if it did not own an equity interest (or the equivalent) greater than 10%, Bell Atlantic still could not hold a controlling position over DataCo. "Control" under the federal securities laws has long meant (as SEC Rule 405 under the Securities Act of 1933 expressly states) "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise." See 17 C.F.R. §230.405. The critical word here is "otherwise," and an elaborate body of case law has indicated that almost any conceivable means can work.

28. Possession of an option is clearly one means by which control can be held or secured. For example, in an early case, the corporation's principal creditor was found to be in control where it held options to acquire the interests of other shareholders, even though the creditor did not actively participate in the direction of the business. See Walston & Co., 7 SEC 937, 947-51 (1940). Even absent an equity interest or an option, persons have been found to be in control. For example, in DeMarco v. Edens, 1996-1997 Fed. Sec. L. Rep. (CCH) Para. 91, 856 at p.95, 935 (S.D.N.Y. 1966), aff'd, 390 F. 2d 836 (2d Cir. 1968), a vice president with day-to-day involvement in the company was found to be a "controlling person" because the corporation's president and sole shareholder was heavily indebted to him, even though the subordinate officer held no equity interest. Other cases have likewise found commercial banks to be controlling persons. See Metge v. Baehler, 762 F. 2d 621 (5th Cir. 1985), cert. denied sub nom, Metge v. Bankers Trust Co., 474 U.S. 1057 (1985); Ferland v. Orange Groves of Fla. Inc., 377 F. Supp. 690, 707 (M.D. Fla. 1974). Professors Loss and Seligman note more generally that a "veto power over mergers or consolidations through ownership of preferred stock, and ... [the] power to 'break quorum' by abstaining from attending the stockholder's meeting or giving a proxy" have long been relevant considerations in evidencing control. See L. Loss and J. Seligman, SECURITIES REGULATION (3rd ed. 1990) at p. 1720 (citing Chicago Corporation, 28 SEC 463 (1948)). Here, these factors are clearly present.

29. Most recently, in SEC v. Cavanagh, 1 F. Supp. 2d 337 (S.D.N.Y. 1998), the central defendants were the principals of an investment banking firm that achieved control of a shell corporation through the use of options. The Court described their arrangement (which changed over time) as follows:

> "At that point in time, the Management Shareholders would have 925, 217 shares, 80% of which would be under Milestone's [the investment banking firm's] control: 542,000 through the option agreement and 200,000 through a lock-up agreement running until March 15, 1997)." Id at 365.

The 80% option arrangement there is not functionally different from the 80% option that Bell Atlantic has arranged here.

30. Here, Bell Atlantic has both the veto power over mergers and acquisitions that the SEC emphasized in Chicago Corporation and the 80% option that the court stressed in SEC v. Cavanagh, supra. Given the Congressional skepticism as of 1934 with stock pools based on options, it seems impossible to deny, either as a matter of Congressional intent or historical fact, that options can constitute a mechanism for holding control. Here, an 80% option effectively immunizes DataCo from any form of capital market discipline, either a takeover or proxy fight, because the insurgent would not be able to profit from replacing the incumbent management. Rather, it would in time be diluted by Bell Atlantic's conversion of its Class B shares, thereby removing the insurgent's incentive to compete for control.

31. Predictably, Bell Atlantic will reply that it does not control DataCo because the latter will have an "independent" board. Even if this were true (which is far from likely), the case law has held it to be largely irrelevant. The existence of an independent board does not preclude a substantial shareholder from being also found to be in control. Put more simply, both a person holding 80% of the corporation's future voting power and an independent board can be controlling persons; one does not exclude the other's control, even if the board is fully independent. See L. Loss and J. Seligman, SECURITIES REGULATION (3rd ed. 1990) at 1713 (quoting M.A. Hanna Co., 10 SEC 581, 589 (1941)).

32. Bell Atlantic has attempted to respond to the entirely foreseeable claim that an 80% option plus board representation gives it control over DataCo by raising several arguments, including (i) that it has no more control over DataCo than AT&T had over MediaOne, (ii) that DataCo will have an independent board, and (iii) that its sole director will be subject to fiduciary duties that render him unable to act on its behalf. Each argument is seriously flawed.

33. The claim that Bell Atlantic has no more control over DataCo than AT&T had over MediaOne is subject to three obvious rejoinders: First, AT&T and MediaOne negotiated their arrangement at arm's length in order to protect their respective shareholders pending the completion of their acquisition. In contrast, while Bell Atlantic and GTE may have similar incentives before their merger closes, they have no reason thereafter to provide for the long-term independence of DataCo. Rather, GTE has only a short-term incentive to protect its shareholders until they receive the consideration to which they are entitled under their merger agreement. After that, neither GTE nor its shareholders have any incentive to resist surrendering DataCo to Bell Atlantic's tender mercies. Second, there is a major difference between short-term protective provisions that seek to preserve the status quo for the limited period between the board's approval of a proposed merger and its closing and the longer and indeterminable post-merger period during which the FCC considers whether to grant Bell Atlantic long distance authorization under Section 271. Under the 1999 merger agreement between AT&T and MediaOne Group, Inc., which I have reviewed, the restriction on MediaOne's operations last only until the effective date of the merger. In contrast, the restrictions on DataCo could last for five years, the maximum period of Bell Atlantic's conversion right. This is a significant difference because veto rights become more important over time and give the holder increasing leverage as time goes by. For

example, it means little to block dividends, borrowing, or sales of assets for the few months between a merger's execution and its closing. But the power to veto or limit dividends for several years is a far greater interference with the board's autonomy and can be used to force or induce management to take actions that the holder of the veto power desires. Third, a final and critical distinction between the standard rights that AT&T was accorded in its merger agreement with MediaOne and Bell Atlantic's power over DataCo involves the nature of the remedy for breach of any of the negative covenants pursuant to which MediaOne and DataCo, respectively, agree not to take certain actions. Under AT&T's merger agreement with MediaOne, AT&T has essentially the right to terminate the agreement and refuse to close if MediaOne were to take a prohibited action.[7] In contrast, Bell Atlantic will have the legal right to force compliance by DataCo with the latter's negative covenants. This power to compel over an extended period evidences control -- the ability to determine the business policies and practices of the controlled company.

34. Bell Atlantic also argues that its one director on the DataCo board is meaningless because that director owes fiduciary duties to all DataCo shareholders. For example, Professor Gilson opines to this effect in his declaration and adds that such a director could not even "participate in any discussions or decisions that would affect ... [Bell Atlantic's] interests."[8]

---

[7] See Agreement and Plan of Merger, dated as of May 6, 1999, By and among AT&T Corp., Meteor Acquisition Inc., and MediaOne Group Inc. (the "Agreement"). In Article 6.1 of the Agreement, MediaOne agrees not to take specified actions, and in Article 10, AT&T is given the right to terminate if certain closing conditions are not satisfied.

[8] While we do not know the jurisdiction in which DataCo will be incorporated, I am aware of no state law or precedent (including the law of Delaware) that goes so far as to preclude all participation in discussions. Precisely because the director is deemed to owe a fiduciary duty to all shareholders, the director may participate in discussions and may lobby other directors. Also, the director may be counted towards a quorum. The interested director can vote, but his vote will not have the effect of conferring disinterested approval sufficient to shift the

(Gilson Declaration at paragraph 23 n. 4). Surely, this is an argument that seeks to prove too much, because it would apply equally well if every DataCo director were a Bell Atlantic nominee. Clearly, no court nor agency would dispute that a board whose majority consisted of Bell Atlantic nominees was "controlled" by Bell Atlantic, but such a board would still owe fiduciary duties as a doctrinal matter to all its shareholders. Ultimately, what this point again illustrates is that control is a factual and empirical question, not a doctrinal one.

35. Finally, it simply cannot be assumed that DataCo will have an independent board (even though such a board would not preclude Bell Atlantic from being a controlling shareholder, as earlier noted). All that Bell Atlantic has truly promised is that eight of the ten directors of DataCo "will have no past or present affiliation with Bell Atlantic or GTE" and that the initial DataCo board will be reelected by the shareholders in two stages within six months and one year, respectively, after DataCo's contemplated initial public offering. See "Response of Bell Atlantic and GTE In Support of Proposal to Transfer GTE Networking to a Separate Corporation Owned and Controlled by Public Shareholders," dated February 22, 2000 at p. 21 n. 21. As a practical matter, this means that Bell Atlantic is free to pick and install the initial board for DataCo. Once such a board is installed, no public shareholder or other person will have any incentive to challenge it (by launching either a proxy fight or a hostile takeover), because Bell Atlantic's right to acquire 80% of the DataCo voting stock would make any such attempt a foolish and futile exercise. Thus, the initial board will persist in office free from capital market discipline or shareholder challenge.

---

burden of proof. All such an interested director cannot do is claim the protection of the business judgment rule for interested actions.

36. Having criticized Bell Atlantic's proposed structure for creating a nominally independent corporation in which it will retain a contingent 80% interest, it is incumbent on me to indicate the kind of structure that would assure the independence of DataCo. In my view, this answer is simple: the same structure that AT&T has already used to preserve the independence of Liberty. As the FCC staff is well aware, Liberty's shares have been distributed by AT&T as a special "tracking stock" of AT&T. If AT&T were to issue additional shares of Liberty, complicated fairness procedures would have to be followed, and the proceeds of the sale would have to be invested in Liberty. Most importantly, if any action is taken to replace the directors of Liberty (all of whom were not picked by AT&T), Liberty is required to convey and assign all its assets to a separate entity, Liberty Media Group LLC, which has no connection with AT&T. The Liberty board is also insulated from AT&T's control because a majority of its board, who were directors or officers of TCI, must remain in office for at least the first seven years. Also, AT&T has no control over the ability of the Liberty board to pay dividends from earnings or capital. In no respect does AT&T hold any option or conversion right on Liberty's earnings or assets.

37. This tracking stock approach could be used here, or an alternative arrangement could be designed by which Bell Atlantic would not hold the power to convert its 10% interest into an 80% interest. I do not mean to suggest that there is only one answer, but only that the FCC has recently seen far better answers than that proposed by Bell Atlantic.

IV. CONCLUSION

38. For the foregoing reasons, I conclude that (i) Bell Atlantic owns the equivalent of a de facto 80% interest in DataCo, (ii) will control DataCo based on its preclusive 80% stake plus board representation and significant veto powers over a long-term period, and (iii)

could design a far more effective means of assuring the autonomy and independence of DataCo pending the FCC's resolution of the Section 271 issue.

I declare under the penalty of perjury that the foregoing is true and correct.

John C Coffee Jr.

John C. Coffee, Jr.

Executed on March 10, 2000